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C O R R E C T E D C O P Y - (PARA NOS.)

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SUBJECT: Pensions Nationalization Proposal Prompts Financial Panic, Market Crash in Argentina

Ref: BUENOS AIRES 1442

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Summary

¶1. (SBU) The Argentine government appears to have been completely unprepared for the plunge in Argentine stock and bond prices following its announcement that it would nationalize the nation's private pension system. GoA officials clearly did not think through the possible negative consequences of this decision, and have struggled to respond to the crisis, with both the GoA Treasury and Central Bank intervening heavily in markets to sustain equity and debt prices, bolster the peso, and prevent massive capital outflows from the banking sector. The President apparently also had to call her Spanish counterpart to reassure him, given the negative impact on the Spanish stock market, and to address rumors of deciding to end negotiations with the Spanish company Marsans over the nationalization of Aerolineas Argentinas.   .

¶2. (SBU) There is a heightened sense of fear and uncertainty in the country, with increasing talk of recession in 2009, concerns about GoA finances and default risks, and a growing sense that no economic sector is immune from GoA intervention. Although the GoA is optimistic about Congressional approval of the bill, Post is hearing of rising opposition to the measure, particularly in the Senate. The GoA may have a larger fight on its hands than it originally expected, and at an incredibly sensitive time for both international and domestic economies. Septel provides additional details about the GoA plan, market reactions, and the increasingly negative outlook for the Argentine economy. End Summary.

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Financial Panic Sparked by GoA Pension Nationalization
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¶3. (SBU) The freefall in stock and bond prices October 21-22 in reaction to the GoA's October 21 announcement that it intended to nationalize the private pension funds (AFJPs) (reftel) appears to have caught the GoA completely unprepared. With the Buenos Aires Stock market dropping over 20% in two days and the country risk premium spiking to over 2,000 basis points, GoA officials struggled

to find ways to halt the market panic they clearly had not anticipated. A high-level source close to the Casa Rosada told DCM October 23 that the markets reaction hit the government "like Hurricane Katrina." Cabinet Chief Sergio Massa is apparently being pulled in a thousand directions at once as he tries to manage both the fallout and demands from the Kirchners, and he is apparently being "overwhelmed" by the multiple challenges the administration is facing.

¶4. (SBU) Several other sources told Ambassador that the small circle that made the pension decision had not anticipated the negative market reactions, but had only considered that the public did not like the private pension system and thus would likely support the GoA's move. As the financial storm mounted, the Kirchners reportedly responded with anger and vigorous efforts to calm the markets, without going back on the decision.

¶5. (SBU) According to press reports (confirmed in general terms by central bank contacts), the GoA reacted October 22 by buying both local bonds and stocks. This intervention seems to have succeeded in halting some of the panic-selling in the stock market, although short-term bond prices continued to fall on October 23. The Central Bank has also intervened heavily in currency markets, selling dollars to bolster the peso and limit incentives for capital outflows from the banking sector. While the BCRA has succeeded in maintaining the peso relatively stable, banks report deposit withdrawals and dollar purchases at rates up to five times higher than normal (albeit still below the worst days of the farm crisis). Argentine media speculates that the GoA is considering further "market-friendly" actions to counteract the negative perceptions of the AFJP nationalization, and Post's contacts among private banks expect this to focus on large scale bond repurchases.

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GoA Motivated by Financial Concerns, but Ignored Unintended Consequences
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¶6. (SBU) Although President Cristina Fernandez de Kirchner has billed this as a "rescue of future retirees from a failed system," Post's contacts (including at the central bank) uniformly agree that the GoA's primary motivation for nationalizing the AFJPs is financial. Facing increasing financing needs in coming years, no access to international credit markets, plummeting commodity prices, and growing fears of recession in 2009, the GoA was clearly desperate for a source of funding to sustain debt payments and keep from having to cut spending in the run-up to the mid-term 2009 elections. While there is disagreement over the actual financial benefit to the GoA, in addition to taking possession of the AFJPs' $30 billion in assets, it is likely to realize inflows of $8-10 billion in 2009 (including contributions, free deposits, and reduced interest and principal amortization on GoA bonds held in AFJP portfolios, see Reftel). This should fortify GoA finances sufficiently to enable it to meet debt payments in 2009.

¶7. (SBU) However, according to a wide range of sources, the President, ex-President, Cabinet Chief and Public Pensions Chief did not appear to have taken into consideration the importance of the private pension system to the financial sector. Not only are the AFJPs the largest purchaser of GoA bonds (which comprise roughly 60% of AFJP portfolios), but they also hold significant equity positions in all the major local companies and banks, are a key source of new financing for companies, and also are the largest source of short-term trade financing. Therefore, by announcing the nationalization (followed by a judicial order prohibiting AFJPs from making any financial transactions in the near term), in one fell swoop the GoA succeeded in cutting off a main trader in the stock exchange and bond markets, eliminating a main source of financing for companies and trade financing for exporter and importers, and raising alarm among companies who now will have a highly interventionist government as a major shareholder and potential board member. The GoA also seems not to have considered that the AFJPs own large stakes in foreign companies, and these positions could be subject to attachment by holdout bondholders after the GoA

takes possession of AFJP assets.

¶8. (SBU) The immediate and negative impact on the Spanish stock market also caught the GoA by surprise and set off a series of consultations. These reportedly included a call from President Cristina Fernandez de Kirchner to Spanish President Zapatero to reassure him about Goa objectives on the pension moves and on the nationalization of Aerolineas Argentinas, where press reported a GoA decision to break off negotiations with the Spanish owners (Marsans).

Fear and Uncertainty Reign

¶9. (SBU) Most local and foreign analysts were already concerned about weakening GoA finances in the face of plummeting global commodity prices and a rapidly decelerating economy. The consensus among Post's banking sector contacts even prior to the October 21 announcement was that Argentina was facing recession in 2009, and default risks were on the rise. While agreeing that the AFJP nationalization most likely reduces the risk of default over the next few years, Post's contacts worry about its medium term impact on the economy. Their main concern now is whether this latest crisis will result in large-scale capital outflows from a now significantly less liquid financial system. However, they also note that AFJPs are the main source of financing in Argentina, and scarcer credit without them could exacerbate the economic downturn, and could enhance the GoA's leverage over the private sector. In the face of this probable credit crunch and expanding GoA presence, Banks now worry they may be the GoA's next target, as the GoA seeks to ensure availability of credit (possibly through old-school Peronist techniques, such as capped interest rates and forced lending). Broadly, there is growing fear that no sector is immune from GoA intervention. (Septel analyzes these issues in more detail.)

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Rising expectations of a tough fight in Congress
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¶10. (SBU) The Ambassador, DCM, and EconOffs have consulted widely

with economists, journalists, bankers, Central Bank (BCRA) officials, and AFJP executives this week, and the initial consensus was that the Argentine Congress would approve the measure relatively easily, albeit possibly with some modifications. The sense was that this issue does not resonate the same as the farmers strike with either Argentine society or Congressional representatives, and also that there is broad dissatisfaction in Argentine society with the retirement system writ large, and the common perception is that the AFJP system (with only 3-5 million mostly white collar regular contributors), was poorly conceived, expensive to administer, and has generally not met expectations. Certainly the GoA is publicly optimistic that it has the votes necessary to get the bill through both houses of Congress.

¶11. (SBU) However, the mood has shifted during the last 36 hours, and there are increasing signs that many political leaders are having doubts. At minimum, it appears that the Senate will push for modifications to the GoA's bill, such as greater controls and transparency with regards to GoA management of the funds. There are increasing calls in Congress for guarantees that no funding from the AFJPs will be used to finance expenditures or make debt payments. Given the assumption that the GoA's primary motivation is to get funds for these purposes, it appears the GoA may have more of a fight on its hands than it bargained for.

¶12. (SBU) Opposition Congressman Esteban Bullrich told the Ambassador October 24 that many opposition Radical party Deputies and Senators, who initially supported the measure, are now leaning towards opposing it. More significantly, Bullrich alleged that during Senate Majority Leader Miguel Angel Pichetto's October 23 meeting with former President Nestor Kirchner (in which Chamber of Deputies Majority leader Agustin Oscar Rossi also was present),

Pichetto insisted that he needed "flexibility to make significant modifications" to the law, in order to get it through the Senate. Kirchner is reported to have rejected this plea, but Pichetto's concern is indicative of how strong opposition to the bill -- at least as currently drafted -- may be in the Senate.

¶13. (SBU) Bullrich further notes that opponents are trying to highlight how costly this measure will be to the Argentine society, a tact that was highly successful during the July Senate vote over the GoA's bill to raise export taxes. Finally, the reactions of the Governors will be key, because Senators are much more responsive to their Provincial constituencies than are lower house Deputies who normally vote party lines. Many Governors are unhappy right now with the GoA, not least because the GoA is said to be broadly delaying both non-discretional and discretional funds transfers to the provinces. (Septel will detail Argentina's co-participation federal/provincial revenue sharing system.)

¶14. (SBU) Post's contacts until recently have also been relatively sanguine regarding concerns about the possible social outcry. For the same reasons stated in Para 6 above, most observers do not expect social protests of the kind that could block the initiative or destabilize the government. While there are efforts (mostly via mass emails) to organize "cacerolazos" (pot-banging) protests, there were doubts about how effective these calls for protest would be. (There are emails calling for a cacerolazo at 8:00 p.m. local time tonight.) That is also changing, according to Deputy Bullrich. He pointed out that he set up a section of his website opposing the AFJP nationalization, and within a day had received 4,000 comments from outraged citizens (most likely AFJP contributors). This was a much faster reaction than he saw during the spring farm strikes, according to Bullrich, and he sees it as evidence that opposition may be building in the public.

Comment

¶14. (SBU) During an October 22 lunch, several highly connected journalists and bankers told Ambassador that some in the private sector had initially characterized the GoA's move as a "brilliant" way to get more funds flowing into the GoA Treasury. However, as the implications set in, most analysts now are portraying it as a blow to Argentina's ability to attract investment, as it provides further evidence of the GoA's willingness to change the rules of the game at whim. It will thus likely reinforce the idea that Argentina is an unpredictable place to invest, and will also undermine GoA

efforts to entice Argentines to repatriate capital back from overseas. This is the overwhelming buzz in elite circles. Most distressing to many in Argentina is the manner in which the GoA concocted this scheme, originating and developing it within a small group, not consulting the AFJPs or the broader financial sector, and disregarding the probable negative consequences that were obvious to most of Post's contacts. Once again the GoA has taken a bad situation and made it worse through its own doing. To paraphrase noted Argentine commentator Eduardo van der Kooy, in his October 23 column in Clarin, the impact of the global crisis on Argentina was the equivalent of a light drizzle, a shower that Cristina and Nestor Kirchner managed to turn into a downpour.

WAYNE